

IRS News Release

Media Relations Office

Washington, D.C.

Media Contact: 202.622.4000

www.irs.gov/newsroom

Public Contact: 800.829.1040

Treasury and IRS Shut Down Abusive Life Insurance Policies in Retirement Plans

IR-2004-21, Feb. 13, 2004

WASHINGTON — Today, the Treasury Department and the Internal Revenue Service issued guidance to shut down abusive transactions involving specially designed life insurance policies in retirement plans, section “412(i) plans.” The guidance designates certain arrangements as “listed transactions” for tax-shelter reporting purposes.

A “section 412(i) plan” is a tax-qualified retirement plan that is funded entirely by a life insurance contract or an annuity. The employer claims tax deductions for contributions that are used by the plan to pay premiums on an insurance contract covering an employee. The plan may hold the contract until the employee dies, or it may distribute or sell the contract to the employee at a specific point, such as when the employee retires.

“The guidance targets specific abuses occurring with section 412(i) plans,” stated Assistant Secretary for Tax Policy Pam Olson. “There are many legitimate section 412(i) plans, but some push the envelope, claiming tax results for employees and employers that do not reflect the underlying economics of the arrangements.”

“Again and again, we’ve uncovered abusive tax avoidance transactions that game the system to the detriment of those who play by the rules,” said IRS Commissioner Mark W. Everson. “Today’s action sends a strong signal to those taking advantage of certain insurance policies that these abusive schemes must stop.”

The guidance covers three specific issues. First, a set of new proposed regulations states that any life insurance contract transferred from an employer or a tax-qualified plan to an employee must be taxed at its full fair market value. Some firms have promoted an arrangement where an employer establishes a section 412(i) plan under which the contributions made to the plan, which are deducted by the employer, are used to purchase a specially designed life insurance contract. Generally, these special policies are made available only to highly compensated employees. The insurance contract is designed so that the cash surrender value is temporarily depressed, so that it is significantly below the premiums paid. The contract is distributed or sold to the employee for the amount of the current cash surrender value during the period the cash surrender value is depressed; however the contract is structured so that the cash

surrender value increases significantly after it is transferred to the employee. Use of this springing cash value life insurance gives employers tax deductions for amounts far in excess of what the employee recognizes in income. These regulations, which will be effective for transfers made on or after today, will prevent taxpayers from using artificial devices to understate the value of the contract. A revenue procedure issued today along with the proposed regulations provides a temporary safe harbor for determining fair market value.

Second, a new revenue ruling states that an employer cannot buy excessive life insurance (i.e., insurance contracts where the death benefits exceed the death benefits provided to the employee's beneficiaries under the terms of the plan, with the balance of the proceeds reverting to the plan as a return on investment) in order to claim large tax deductions. These arrangements generally will be listed transactions for tax-shelter reporting purposes.

Third, another new revenue ruling states that a section 412(i) plan cannot use differences in life insurance contracts to discriminate in favor of highly paid employees.

Copies of the proposed regulations, the revenue procedure, and the two revenue rulings are attached.